BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF DELAWARE,
THE DELAWARE ENERGY OFFICE,
THE OFFICE OF MANAGEMENT AND BUDGET,
AND THE CONTROLLER GENERAL

IN THE MATTER OF INTEGRATED RESOURCE PLANNING FOR THE PROVISION OF STANDARD OFFER SUPPLY SERVICE BY DELMARVA POWER & LIGHT COMPANY UNDER 26 *DEL. C.* § 1007(c) & (d): REVIEW AND APPROVAL OF THE REQUEST FOR PROPOSALS FOR THE CONSTRUCTION OF NEW GENERATION RESOURCES UNDER 26 *DEL. C.* § 1007(d) (OPENED JULY 25, 2006)	PSC DOCKET NO. 06-241

RESOLUTION AND COMMENTARY ON DISPUTED ISSUES IN THE DELMARVA/BLUEWATER POWER PURCHASE AGREEMENT

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1. I have been designated by Order No. 7328 dated December 4, 2007 in this proceeding (the "December 4 Order") to resolve disputes between Delmarva Power & Light Company ("Delmarva") and Bluewater Wind Delaware LLC ("Bluewater") concerning the terms of the Power Purchase Agreement ("PPA") between them. On December 10, 2007, as a result of the process mandated by the December 4 Order, I submitted to the designated agencies in this proceeding (the "Agencies") the form of PPA negotiated by Delmarva and Bluewater (the "December 10 PPA"). As noted in that submission, it was necessary for me to resolve several disputes between Delmarva and Bluewater in arriving at the form of the December 10 PPA, and, as will be explained more fully below, Delmarva objects to a number of important elements of the December 10 PPA.

2. As contemplated in the December 4 Order, I have been assisted by Barry Sheingold of New Energy Opportunities, Inc., the Independent Consultant (the "IC") to the Public Service Commission (the "PSC") and the other Agencies. The IC's advice (including assistance from the IC's counsel, Donald S. McCauley, Esquire, of McCauley Lyman LLC) has been invaluable to both me and the parties in completing the preparation of the December 10 PPA. Likewise, I note that the parties – including their counsel, consultants and representatives – have, under extraordinary time pressure, worked as hard and efficiently as possible to fulfill the mandate of the December 4 Order. No reasonable person who observed the parties' intensive, expedited and forthright efforts to identify issues, explain their respective positions and rationales, and explore alternative approaches in order to resolve issues, could conclude that either Delmarva or Bluewater conducted the negotiations in anything other than the utmost good faith.

3. All of the participants in the negotiations mandated by the December 4 Order, however, have acknowledged that the December 10 PPA has not been agreed to by the parties. More specifically, and as explained more fully below, I understand that Delmarva will assert that various aspects of the December 10 PPA are inappropriate, and that the December 10 PPA should be rejected by the Agencies.

4. In several instances, Delmarva's objections relate to matters on which I did not make an independent determination:

a. Most notably, the pricing provisions of the December 10 PPA – Section 4.2(a) – represent Bluewater's proposal, not accepted by Delmarva.

b. Similarly, the contract output of the proposed offshore wind generation facility (the "Project") of up to 300 MWh pursuant to Section 3.1(a)(i)(B) – a size at or near the upper end of the range prescribed in the Agencies' Findings, Opinion and Order No. 7199 dated May 22, 2007, ¶55 – is not acceptable to Delmarva.

c. Delmarva continues to assert that the Project term – with a Guaranteed Initial Delivery Date of June 1, 2014 (Section 1.1), a Date Certain of November 30, 2015 (Section 5.4(b)), and a 25-year services term (Sections 1.1 and 2.1) – is unduly long.

d. Delmarva asserted during negotiations that the PPA should delay its effective date until enactment of legislation spreading the costs of the Project to all of Delaware's electricity customers.

e. Delmarva objects to Section 3.5(e) that imposes upon it the risk of PJM charges that may arise where actual energy output from the Project varies from amounts presented in day-ahead forecasts provided to PJM.

5. Because I believe that the foregoing disputed issues are ones which are most appropriately evaluated by the Agencies themselves, as advised by PSC Staff and the IC, I did not resolve them. Moreover, I do not attempt here to recite or evaluate the

contentions of the parties with respect to them. With respect to other disputed issues that arose during the negotiations, however, I do attempt below to describe the rationales for the judgments I did make. Even the descriptions below, however, are not comprehensive recitations of the parties' contentions and concerns with respect to those other disputed issues.

FIN 46 (Section 12.4)

6. The most divisive and time-consuming issue in the negotiations was the treatment of a risk that, by all accounts, is extremely unlikely to arise. That risk involves the possibility that the assets and liabilities associated with the Project will, at some indeterminate point in the future, be required to be consolidated on Delmarva's financial statements under FASB Interpretation No. 46, or "FIN 46". The particular risk addressed by the parties that might bring about this consolidation is the possibility of amendments to FIN 46.

7. Neither of the parties contends that such financial consolidation would be required under current accounting rules. Notably, confirmation of that proposition is a condition precedent to the effectiveness of the December 10 PPA (Section 5.1(a)(iii)). Likewise, both parties seem to acknowledge that even if pertinent accounting rules did change in a manner that would otherwise call for consolidation of the Project on Delmarva's financial statements, it is most likely that the original accounting treatment of the Project and the December 10 PPA would be "grandfathered," in which case such original treatment would continue to apply. I therefore believe that it would be most unfortunate if the disposition of an issue as speculatively problematic as the treatment of a FIN 46 consolidation event contributed in any material way to the Agencies' overall approval or disapproval of the December 10 PPA.

8. Because it perceives that the adverse effects of consolidation would be severe, however, Delmarva has vigorously asserted that it should be absolutely protected from FIN 46 consolidation risk. In particular, it has sought the absolute right to terminate the PPA if a FIN 46 consolidation were required, and could not be cured promptly by Bluewater. On the other hand, Bluewater has expressed grave concern that an event not of its own making (an accounting rules change) could permit Delmarva to abandon the PPA, leaving Bluewater unable to recoup its substantial investment in the Project without any protection under the terms of the PPA.

9. Two of the Agencies, the Commission and the Delaware Energy Office, acknowledged the legitimacy of both parties' concerns with regard to the FIN 46 consolidation issue. *See* Order No. 7081 (November 26, 2006) (amending paragraph 88 of Order No. 7066) ("we are concerned about the effect on the contract party [Bluewater, in this instance] as well as on DP&L and on Delaware's customers"). Those two agencies sought a resolution that "best balances the concerns of a contract party that has invested money into performing under the contract with the concerns of DP&L and its ratepayers as to the potential damages to DP&L that would result" upon consolidation.

Id. I agree with these observations, and have selected an approach to the issue, described below, that I believe best accounts for these considerations.

10. Section 12.4 of the December 10 PPA is the provision that articulates my approach to the FIN 46 consolidation issue. It is a provision that satisfied neither party when it was proposed during the recent negotiations. Although Bluewater subsequently indicated its willingness to enter into the December 10 PPA, it undoubtedly strongly preferred a provision that would have protected it against any loss arising from a termination based upon a FIN 46 consolidation.

11. In any event, Section 12.4 proceeds from the premise that it is impossible at this point to anticipate (i) when a consolidation might be required, (ii) what precise event might bring about such a requirement, (iii) what changes in the structure of Bluewater or in the terms of the PPA might suffice to avoid consolidation, or (iv) the precise implications for Delmarva, Bluewater and Delmarva's customers if the PPA were terminated, continued with consolidation, or continued following changes in its terms or in Bluewater's structure in a manner that would avoid consolidation. Perhaps because of all of these uncertainties, neither the parties nor I were able to identify and agree upon specific measures that might prescribe a way to avoid the FIN 46 problem, or to allocate the risks of harm stemming from a FIN 46 consolidation event.

12. Accordingly, the only solution I considered fair and appropriate was one in which an independent assessment of appropriate measures would be made if and when a FIN 46 consolidation were actually threatened, and the potential effects of such a consolidation and measures that might avoid it could be evaluated in a concrete context. Section 12.4 thus establishes a process in which, following notice of a threatened FIN 46 consolidation, an independent evaluator would initially recommend potential means to remedy the circumstances creating the FIN 46 determination. The independent evaluator would give preference to remedies that would avoid consolidation pursuant to FIN 46, avoid termination of the PPA, and, to the extent practicable, minimize adverse impacts – including impairment of the benefits of the PPA – on the parties and on Delmarva's customers. If the parties were unable to agree upon a solution recommended by the independent evaluator, the Commission would then be called upon to determine the matter, directing one or more remedial measures that might include, for example, termination of the PPA, alternative means or levels of performance of the terms of the PPA, or payments from one party to another as a condition to termination or continuation of the PPA. Again, the parties would expect that in choosing one or more appropriate remedies, the Commission would give preference to remedies that would avoid consolidation pursuant to FIN 46, avoid termination of the PPA, and, to the extent practicable, minimize adverse impacts – including impairment of the benefits of the PPA – on the parties and on Delmarva's customers.

13. In the negotiations, Delmarva asserted that Order No. 7081 predetermines the appropriate disposition of the FIN 46 issue, prohibits any variation from the procedure described in that Order, and therefore precludes the adoption of Section 12.4. I do not find this assertion persuasive, however, for two principal reasons. The first reason is

formalistic: Order No. 7081 "reserve[d] jurisdiction and authority to enter such further Orders in this Docket as may be deemed necessary or appropriate." This express provision eliminates any legal obstacle to a modification of the process contemplated in Order No. 7081, if all of the Agencies (including the two agencies that did not approve Order No. 7081) conclude that such a modification is fair and appropriate.

14. Second, and more substantively, I do not read Order No. 7081 as narrowly as Delmarva. That Order did establish a dispute resolution mechanism that contemplated a brief period in which the contract party (Bluewater, in this case) could "cure the problem" – presumably, take steps to avoid consolidation – and, if unable to do so, could appeal to the Commission so that the Commission could "review DP&L's determination" – presumably, the determination by Delmarva to treat the consolidation as an event terminating the PPA – "and make a decision as to whether it agrees with DP&L's determination … ." I do not see any language in Order No. 7081, however, that would have limited the scope of (i) the Commission's review of Delmarva's decision to terminate the PPA, (ii) the considerations that the Commission could bring to bear in deciding whether it agreed with Delmarva's termination decision, or (iii) the Commission's discretion in terms of how to resolve the situation. Therefore, I see nothing inconsistent with Order No. 7081 in a provision, like Section 12.4, that simply fleshes out the process and the considerations governing how the parties and the Commission would examine what to do about a FIN 46 consolidation event. To the contrary, and as noted earlier, I believe that Section 12.4 best accomplishes the goals of fairness and balance reflected in Order No. 7081.

Negative LMP (Section 3.4(d))

15. Because the December 10 PPA locates the "Point of Receipt" of energy under the PPA at Delmarva's Indian River substation, along a substantially higher voltage line than the one serving the originally contemplated Bethany substation, Delmarva has agreed to bear the risk of charges by PJM arising due to negative Locational Marginal Price ("LMP"), a risk that is likely to be minimal as long as intermittent power generation resources entering the power grid south of the C&D Canal do not substantially exceed those associated with the Project. The parties disagreed, however, about the treatment of negative LMP if new intermittent resources begin generating electricity without installing optional as well as required network upgrades identified in PJM facilities studies. Bluewater maintains that Delmarva agreed in the Term Sheet dated September 14, 2007 to assume all risks associated with negative LMP. Delmarva counters, however – and I agree – that the Term Sheet was based on delivery at the Bethany substation and did not address the negative LMP risks associated with new intermittent generation.

16. Initially, the risks associated with negative LMP appear to be quite low. Nevertheless, those risks, whatever their level, need to be allocated, and I found no obviously correct way of doing so. My sense, however, was that the allocation of such negative LMP charges should depend on the extent to which the new intermittent resources are attributable to Bluewater. Therefore, Section 3.4(d) of the December 10 PPA contains a formula that increases Bluewater's share of negative LMP charges as its

share of new intermittent resources increases. Bluewater's share of negative LMP charges would be 50% at a minimum, rising, to a maximum of 80%, in proportion to its share of overall intermittent resources. The trigger for the formula is the construction of 75 MW of new intermittent generation without optional network upgrades.

17. This resolution has two virtues. First, it discourages Bluewater from adding new intermittent resources without investing in transmission upgrades that would help avoid negative LMP charges. Second, and conversely, it is not inappropriate to place at least some of the negative LMP charges upon Delmarva (and indirectly upon Delmarva's customers), because such charges would presumably arise in an overall context in which new intermittent generation (wind and possibly solar) would suppress market energy prices, thereby benefiting Delmarva's customers.

Assignment (Changes in Control) (Section 14.5(a))

18. Section 14.5(a) of the December 10 PPA provides Delmarva the right to consent to a transfer of the Project by Bluewater (or a successor seller), provided that Delmarva's consent is not unreasonably withheld upon a showing of the proposed assignee's technical and financial ability to fulfill the seller's obligations under the PPA. Delmarva has a similar right of prior consent with respect to a change of control of Bluewater (or a successor seller). Section 14.5 eliminates that latter consent right, however, in two circumstances that were at issue in the negotiations: (i) a public offering of interests in the seller on a major stock exchange, and (ii) an acquisition of control of the seller by an entity with gross assets of over $10 billion (giving effect to ownership of the Project and to adjustment for inflation). In each case the seller's technical and financial ability to perform under the PPA must be unimpaired.

19. I concluded that the preservation of Delmarva's prior consent right where an assignment or a change of control would impair the seller's technical or financial ability to perform under the PPA affords sufficient assurance to Delmarva and its customers that their interests under the PPA would be protected. Any added protection achieved by requiring Delmarva's prior consent to changes of control that do not impair the seller's technical or financial ability in the circumstances described above is outweighed by the potential for impeding legitimate changes of control of the seller or public financings that do not implicate any significant concerns about performance under the PPA. I do not view any such concerns as significant unless the Project represents a very substantial portion of the assets controlled by the person acquiring control of the seller.

Contract Capacity (Section 1.1)

20. The definition of "Contract Capacity" in the December 10 PPA reflects the resolution of a dispute over the extent of Bluewater's discretion to submit capacity bids to PJM. The parties agreed on the following: (a) Bluewater would be responsible for bidding capacity into PJM's RPM Market and it would receive payment from Delmarva at the contract price for the amount of cleared capacity up to the contract maximum of 105 MW; and (b) Bluewater would effectively guarantee that a minimum percentage of

the Project's actual Capacity Value would clear the PJM auction and would be sold to Delmarva. The parties disagreed on the years that the minimum Capacity Value guarantee should apply and the level of the guarantee. Delmarva was concerned that Bluewater might in some circumstance "game" its bid with the possible result that less than a reasonable amount of the Capacity Value of the Project might clear the RPM auction. Bluewater stated that it had no incentive in bidding other than to maximize its sale of capacity while protecting itself from bidding a quantity higher than it might deliver (in which case it might be financially penalized). In contrast, Delmarva, as a purchaser of capacity under the PPA, understandably wishes to maximize the capacity Bluewater is committed to sell, and to minimize Bluewater's discretion in bidding.

21. The resolution of this dispute reflected in the PPA definition of Contract Capacity affords Bluewater greater discretion than Delmarva wished, although somewhat less than Bluewater's position. While the selected approach accepts Bluewater's requested band of discretion (80%) during the first two capacity years for which it can bid in the PJM residual base auction after three years of operational experience, that band of discretion narrows to 85% in subsequent years, in light of the fact that the need for such discretion can be expected to decline as operating experience becomes more mature and statistically reliable.

22. Like many other issues that arose during the negotiations, the concern over Bluewater's capacity bidding discretion may be more theoretical than real. As a seller of capacity, Bluewater is unlikely to have an incentive to underbid capacity. Accordingly, I accept that its motivation for seeking bidding discretion is to avoid penalty charges.

Extension of Milestones on Account of Litigation by Delmarva or Affiliates (Section 13.4)

23. From the inception of negotiations earlier this year, Bluewater has expressed concern that litigation by Delmarva or its affiliates would prevent the timely satisfaction of various milestones specified in the PPA. For its part, on the other hand, Delmarva has insisted that it cannot control the actions of its affiliates, and therefore does not want to in effect extend the term of the PPA (a term it already considers too long) if litigation by one of its affiliates delays completion of PPA milestones.

24. Throughout the negotiations, it has appeared to me that this dispute is, again, more theoretical than real. I find it likely that any appeals would be concluded within 18 months after entry of a final order approving a PPA. The conclusion of litigation will most likely occur well before Bluewater would be required to make the most serious commitments under the PPA – specifically, the financial closing and the notice to proceed with construction, both scheduled for 2012. In short, it is extremely unlikely that litigation will continue to a point that it would interfere with decisions to obtain financing and begin construction of the Project. On the other hand, if litigation were to proceed beyond that point, Bluewater's understandable reluctance to make major financial commitments to the Project in the face of litigation challenging the PPA may well impair its ability to satisfy the PPA's milestone requirements.

25. Section 13.4 of the December 10 PPA reflects these perceptions. Even if litigation challenging the PPA continues up to September 30, 2009 – nearly two years from now – the PPA milestone deadlines will not be affected. If and only if litigation by Delmarva or its affiliates continues past that date could those deadlines be extended. Moreover, such an extension will occur only if and to the extent that Bluewater can demonstrate that the litigation will reasonably delay completion of one or more PPA milestones, and any such extension is limited to one day for each day that the litigation continues past September 30, 2009.

26. The inclusion of litigation by a Delmarva affiliate, as well as by Delmarva itself, in the provision for extending PPA milestones means that such an affiliate (including Delmarva's parent company) may be required to take into account, in conducting litigation challenging the PPA, the potential impact of extending PPA milestones. There should be no implication or presumption from this inclusion, however, that litigation by any Delmarva affiliate has resulted or will result from any act or omission by Delmarva.

Delmarva Lien on Shared Facilities (Section 8.3(b))

27. The parties were unable to agree on the treatment of Delmarva's lien on Project offshore transmission facilities that are built, owned and maintained by Bluewater, and that might ultimately be used by another wind generation facility, as well as by the Project. Anticipating the possibility of construction of additional offshore wind production adjacent to the Project, Bluewater may well construct offshore facilities that would be larger than necessary to accommodate the demands of the December 10 PPA. The issue in question would arise if lenders financing that other facility obtained a lien, with equal priority to Delmarva's, on the shared facilities. Delmarva wishes to preserve its ability to exercise otherwise available creditor remedies, in the event of a default, with respect to the shared facilities, unimpeded by an equal priority lien held by third parties with respect to those same facilities.

28. I appreciate Delmarva's concern on this point, but I concluded that Bluewater's response was sufficient. Specifically, Section 8.3(b) provides that while Delmarva must negotiate an intercreditor agreement with respect to the shared facilities with the lender(s) to the additional project, that intercreditor agreement may not impair Delmarva's rights to use the shared facilities in exercising its rights under the PPA. In other words, while Delmarva may not be able to break up or sell off the physical assets of the shared facilities to satisfy its claims under the PPA without the consent of the lenders to the other project, Delmarva will at least be assured that the use of the shared facilities to service the Project will not be impaired. I concluded that this assurance adequately protects Delmarva and its customers, especially in light of other forms of security afforded to Delmarva under the December 10 PPA.

Payment to Bluewater for Reduction in Capacity Value Due to Delmarva Unexcused Failure (Section 3.16(c))

29. Bluewater insisted that if Delmarva fails to buy delivered energy as required by the PPA, and that failure results in a reduction of the capacity value of the Project, Delmarva must compensate Bluewater for the resulting reduction of capacity. I accepted that position as an appropriate formulation of what most likely would have been a standard calculation of damages for breach of contract. I note that the final version of the December 10 PPA includes a limitation, inserted by the parties themselves, that reduces Delmarva's share of compensation for reduced capacity from 100% to 92%. Needless to say, because that reduction that favors Delmarva is apparently acceptable to Bluewater, I have no objection to it.

Allocation of Costs Due to Revised Resource Adequacy Requirements (Section 3.14)

30. In the December 10 PPA, as well as in the Bluewater Term Sheet (p. 4), the parties have attempted to address the consequences of any future regulatory scheme that might require Bluewater to incur additional costs in order to assure that the capacity associated with the Project satisfies new resource adequacy requirements ("RAR's") applicable to Delmarva. The parties have agreed that if such additional costs arise but do not exceed $200,000 in a given year or $500,000 during the term of the PPA, Bluewater will bear those additional costs.

31. Bluewater has maintained that Delmarva should be responsible for any further costs arising from RAR's associated with any future change in regulatory rules. In Delmarva's view, however, the intent of the Term Sheet on this point was to limit Delmarva's responsibility to situations where such additional costs arise only as a result of imposition of an entirely new regulatory scheme, rather than incremental amendments of existing rules.

32. I did not read the term sheet as narrowly as Delmarva, however, and I found it appropriate that costs above the $200,000/$500,000 limit be borne by Delmarva (and, if appropriate, its customers), because those costs would be incurred at Delmarva's direction and for its benefit in order to satisfy RAR's applicable to Delmarva.

/s/ Lawrence A. Hamermesh
Lawrence A. Hamermesh

DATED: December 12, 2007